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No. 711

IN THE

Supreme Court of the United States

OCTOBER TERM, 1961

AARON M. NADLER,
Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,
Respondent,

SECURITIES CORPORATION GENERAL,
Intervenor,

DYNAMICS CORPORATION OF AMERICA,
Intervenor.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR INTERVENOR DYNAMICS CORPORATION OF AMERICA IN OPPOSITION

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March 9, 1962

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Opinions Below

The opinion of the United States Court of the Second Circuit is reported at 296 F. 2d 6 forth in the petition at pp. 27-30. The findings orders of the Securities and Exchange Commis forth in the petition at pp. 30-57.

Jurisdiction

The jurisdictional requisites are adequately set forth in the petition.

Question Presented

Does an inadvertent failure by a registered investment company to comply with the director election provision of Section 16(a) of the Investment Company Act of 1940 render void, rather than voidable, either

(1) a transaction found by the Commission to be non-discriminatory, fair and reasonable, consistent with the investment policy of the company and consistent with the purposes of the Act, or

(2) the application by the company to the Commission for an exemption for such transaction pursuant to Sections 17(b) and 23(c) of the Act, or

(3) an order of the Commission so exempting such transaction?

Statute Involved

In addition to the sections of the Investment Company Act of 1940 printed in the petition at pp. 58-63, Section 6(c) of that Act is also pertinent:

> "Sec. 6. (c) The Commission, by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection

of investors and the purposes fairly intended by the policy and provisions of this title."*

Statement of the Case

Late in 1959 Securities Corporation General, a registered investment company incorporated under the laws of Virginia (hereinafter called SCG), negotiated an agreement to sell 77,395 shares of Common Stock of Anemostat Corporation of America (hereinafter called Anemostat) to Dynamics Corporation of America (hereinafter called Dynamics), in exchange for $155,820 in cash and 4,757 shares of SCG Preferred Stock. The agreement was made subject to issuance of an exemption order by the Securities and Exchange Commission (hereinafter called the Commission) under the Investment Company Act of 1940 (hereinafter sometimes called the Act) because Dynamics was an "affiliated person" of an "affiliated person" of SCG (Sections 17(a) and (b))** and because SCG would be acquiring its own stock (Section 23(c)). SCG applied for the requisite exemption order, the Commission gave the statutory notice to stockholders and, on December 30, 1959, after finding that the transaction was fair and reasonable and otherwise met the statutory standards of exemption, the Commission issued an order exempting the proposed transaction.

In May and June of 1960, having been informed by petitioner that the directors of SCG had been elected in violation of Section 16(a) of the Act (*i.e.*, seriatim

*When incorporated in the U. S. Code as 15 U. S. C. § 80a-6(c), Section 6(c) was expanded to accommodate amendments to the Bankruptcy Act appearing in other sections of the Investment Company Act of 1940.

**The affiliation between Dynamics and SCG was by virtue of common affiliation with Anemostat. See Section 2(a)(3) of the Act.

by incumbent directors rather than by the stockholders), the Commission conducted a public hearing to determine whether or not it should revoke its 1959 exemption order. Petitioner, SCG Dynamics and the Division of Corporate Regulation of the Commission participated in hearings before a trial examiner, compiling a record of almost 2,000 pages, and submitted briefs to and presented oral argument before the Commission. The Commission considered the facts with respect to the election of the SCG directors and concluded that the failure to comply with Section 16(a) had been inadvertent. The Commission noted that by then the stockholders had properly elected the same directors (their original election had been in compliance with Virginia law, but admittedly not with Section 16(a)) and had ratified the transaction in question. In addition, after petitioner had examined intervenors' officers at length and propounded the same unsupported allegations of misconduct alleged and insinuated without foundation in the petition to this Court, the Commission held that petitioner had failed to establish wrong-doing, fraud or overreaching, and that there was no basis for reversal of its earlier findings that the transaction was fair and reasonable, non-discriminatory, consistent with the investment policy of SCG and consistent with the general purposes of the Act. Therefore, in December 1960, the Commission issued findings and an opinion and entered an order discontinuing the proceedings, thereby leaving undisturbed the 1959 order.

The Second Circuit affirmed the Commission [illegible] and petitioner, seeking to set aside both the 1959 and the 1960 orders of the Commission, now petitions this Court for review that affirmance.

Argument

I.

THE INADVERTENT FAILURE TO COMPLY WITH SECTION 16(a) OF THE ACT DID NOT VOID EITHER THE TRANSACTION OR THE APPLICATION TO THE COMMISSION FOR AN EXEMPTION FOR THE TRANSACTION OR THE COMMISSION'S EXEMPTION ORDER.

Although petitioner's first three reasons for granting the writ ask the Court to construe Section 16(a), petitioner never comes to grips with the question presented by this case: does non-compliance with Section 16(a) render void or merely voidable a subsequent transaction or Commission exemption? Only if such transaction and exemption are void should the Court consider setting aside the orders of the Commission. If the transaction and exemption are merely voidable, the conclusions of the Commission after a full hearing—that the failure to comply was inadvertent, that the terms of the transaction were fair and reasonable and that there was no fraud or overreaching—should not be disturbed in the absence of an abuse of the Commission's discretion.

The Court of Appeals held that a transaction authorized by a board of directors not elected as required by Section 16(a) is not void. It noted the harm to stockholders which would flow from such an arbitrary rule—harm which the record shows would flow to the stockholders of both SCG and Dynamics were they required to unwind the transaction at issue—and held that an act by such a board is merely voidable. Thus, the court concluded, the Commission has discretion to decline to revoke its exemption for a particular transaction when that transaction is fair and reasonable. In the Court of Appeals petitioner urged repeatedly that the

Commission had no such discretion. Petitioner now has abandoned that basic position, seeking instead to confuse the issue by quibbling with the Second Circuit's reference to the statutory discretion to extend the period of time within which an incomplete board may arrange for a stockholders' meeting to complete the board.

Section 6(c) of the Act compels a conclusion quite contrary to petitioner's assertion that a transaction—any transaction—is void if authorized by a technically improperly elected board. That section grants the Commission the power

> "... conditionally or unconditionally [to] exempt any person, security, or transaction ... from any provision or provisions of this title ..., if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title."

The reason for the inclusion in the Act of such broad exemptive power is particularly important in the instant case. The Act was adopted as an affirmative means of controlling actual abuses in the investment company industry, not as a formally constructed trap for the unwary—a distinction evident from the pattern of the Act, which combines strict regulatory provisions with extremely broad exemptive powers lodged in the Commission as the regulatory agency. In the petition (pp. 13-14) petitioner cites the definitive article of Alfred Jaretski, Jr. to elucidate the underlying purpose of Section 16(a)—the prevention of serious infringement of shareholders' rights through unscrupulous inside manipulation. Later in the same article Mr. Jaretski points out that Section 16(a) and other provisions of the Act are moored to their substantive foundations by sweeping grants of exemptive power to the Commission:

> . . . Without these exemptive powers and without a wise exercise of discretion thereunder, the Act would be unworkable, unduly restrictive, and would cause unnecessary hardships." Jaretski, *The Investment Company Act of 1940*, 26 Wash. U. L. Q. 303, 344 (1941).

Thus, in determining that SCG's failure to comply with Section 16(a) merely rendered the 1959 order voidable rather than void, the Commission did no more than exercise its discretionary power to prevent an inadvertent error from causing an unreasonable hardship. The Commission found (i) that an election was held which, while it failed to comply with Section 16(a) because of a simple lack of familiarity with that Section of the Act, was in accord with the applicable state law and with the by-laws of the corporation; (ii) that the persons who caused the new directors to be elected held a majority of the outstanding shares and thus could easily have elected the same directors with the requisite formality of a shareholders' meeting; (iii) that the new directors, instead of concealing their election, filed reports of their stock ownership and assumption of office with the Commission; (iv) that the same directors had been subsequently re-elected and their acts ratified by a shareholder vote; (v) that despite the unintentional violation of Section 16(a), the application for the 1959 order was filed by a properly-elected president; (vi) that the transaction authorized by the 1959 order was negotiated at arm's length and in good faith; (vii) that such transaction was reasonable and fair and involved no overreaching; and (viii) that subsequent events showed that the timing of the Anemostat transaction benefited SCG whereas rescission would have been to its detriment. In the light of those facts, the Commission acted well within its discretionary power under Section 6(c) in refusing to revoke its 1959 order.

Reference to previous Commission decisions under Sections 6(c) will demonstrate that any other ruling in the present case would have been inconsistent both with prior Commission practice and with the substantive policies of the Act. *E.g., Transit Investment Corp.*, 28 S. E. C. 10 (1948); *Hugh B. Baker*, 24 S. E. C. 202 (1946). See *Graham-Newman Corp.*, 28 S. E. C. 133 (1948).

The granting of a retroactive exemption under Section 6(c) has received its most recent stamp of judicial approval in *Hennessey* v. *SEC*, 293 F. 2d 48 (3d Cir. 1961).

That the Commission's discretion under Section 6(c) extends to Section 16(a), as well as to all the other sections of the Act, seems clear from a long series of decisions under Section 6(c) expressly exempting investment companies in their organization stages from the shareholder vote requirements of Section 16(a). *E.g., Centennial Fund II, Inc.*, SEC Investment Co. Act Release No. 3272 (June 13, 1961); *Naess & Thomas Special Fund, Inc.*, SEC Investment Co. Act Release No. 3053 (June 23, 1960); *The One William Street Fund, Inc.*, SEC Investment Co. Act Release No. 2710 (May 8, 1958); *Scudder Special Fund, Inc.*, SEC Investment Co. Act Release No. 2365 (June 5, 1956).

In the present case, where the inadvertent violation of Section 16(a) is without relevance to the substantive fairness of the Anemostat transaction, petitioner is merely attempting to use a technical defect as a crowbar to force apart a transaction whose business justification he personally disputes. By refusing to revoke its 1959 order, the Commission did no more than implicitly exempt an inadvertent violation of Section 16(a) subsequently cured by an election of directors. Unless the Court believes, therefore, that the Commission has no discretion to exempt a fair and equitable transaction simply because it was authorized by a

board elected in inadvertent violation of Section 16(a), the petition is without merit.

II.

THE COURT OF APPEALS DID NOT HOLD THAT A STOCKHOLDER OF A REGISTERED INVESTMENT COMPANY HAS NO INDEPENDENT RIGHT TO ATTACK IN THE COURTS TRANSACTIONS IN VIOLATION OF THE ACT

The fourth and fifth reasons given by petitioner for granting certiorari (as well as the third, fourth and fifth of his "questions presented" and Point II of his petition) all proceed on the erroneous conclusion that the Court of Appeals held that a stockholder of a registered investment company does not have a right to attack directly in a Federal court a transaction allegedly in violation of the Act. Such a conclusion is utterly without foundation, either in the context of the petition to the Court of Appeals to review the Commission's orders or in the language of the decision of the Second Circuit itself. Whether or not such a right exists was not decided by the Commission, was not a relevant issue before the Court of Appeals (although raised by petitioner in his reply) and could not be decided in this proceeding.

The Court of Appeals did not pass upon the jurisdiction of a district court. The Court of Appeals concluded simply that the Commission acted within its power when it concluded that an exemption should not be withdrawn because of inadvertent non-compliance with Section 16(a) of the Act. Petitioner argues (p. 20) that the Commission does not have power to "void" a transaction because of a violation of Section 16(a), but certainly the Commission upon re-examination could have withdrawn its exemption had it found the transaction to be discriminatory, or unfair or unreasonable, or inconsistent with the investment policy of the

[illegible] investment company, or inconsistent with the purposes of the Act. A violation of Section 10(a) would be a relevant consideration in reaching any such conclusion, but the Commission concluded instead that the exemption should not be withdrawn because of the inadvertent violation.

There is, to be sure, a conflict in the circuits that exists between the decision of the Second Circuit in *Brown* v. *Bullock*, 294 F. 2d 415 (2d Cir. 1961), and the Eighth Circuit in *Brown* v. *Maryland Funds, Inc.*, 280 F. 2d 901 (8th Cir.), cert. granted, 366 U. S. 928 (1961). Parenthetically, however, it should be noted that the Second Circuit concluded that the stockholder does have an independent right of action. Doubtless the Second Circuit does not regard its *per curiam* opinion in this case as reversing its earlier decision in *Brown* v. *Bullock*, and petitioner's assertion that, in effect, it does is without merit. It is petitioner's voluntary consent to the dismissal with prejudice of his district court action, and not the decision of the Second Circuit in this case, which today prevents petitioner from making any further attack on the Commission's orders in the district court.

Petitioner's Point III, to the effect that he has been deprived of his day in court, is equally without merit. For the reasons stated above, clearly the Second Circuit has not held that petitioner has no right to a day in court. Indeed, the Court of Appeals observed that petitioner "was given a very full hearing", after which the Commission "made an extensive review of the evidence and found that there was no evidence of fraud or overreaching in the transaction and that the terms and considerations of the transaction were fair and reasonable. So it declined to revoke its exemption." 296 F. 2d at 64.

Notwithstanding, petitioner asserts that "there have never been any proceedings before the SEC for an order

exempting the transaction from Section 16(a) of the Act." (Petition, p. 28.) But as demonstrated at p. 7, *supra*, the Commission, in reviewing the transaction at length, considered all of the facts petitioner could adduce with respect to the Section 16(a) violation and concluded that it was inadvertent and had been subsequently cured. Hence, to remand this case now for a specific application to the Commission for exemption would be a meaningless gesture in the face of the Commission's clear determination that the transaction was properly exempted.

Conclusion

For the foregoing reasons it is respectfully submitted that the petition for a writ of certiorari should be denied.

Respectfully submitted.

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March 9, 1962.